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In the Supreme Court of the United States

October Term, 1959

No. 215

THE DENTON & ANDERSON COMPANY, ET AL.,
PETITIONERS

v.

THOMAS G. KAVANAGH, ADMINISTRATOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 35a-56a)[1] is reported in 164 F. Supp. 372. The *per curiam* opinion of the Court of Appeals (Pet. 25-26) is reported in 265 F.2d 930.

JURISDICTION

The judgment of the Court of Appeals was entered on April 22, 1959 (Pet. 25-26), and the peti-

[1] Record references are to the separate "Appendix to Brief of Appellants" filed with the Court of Appeals.

tion for a writ of certiorari was filed on July 16, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

In consolidated income tax returns, two parent corporations took deductions for a subsidiary's operating losses. Subsequently, the parents made payments on their guaranties of the subsidiary's indebtedness, and the subsidiary was liquidated. The following questions are presented:

1. Whether amounts paid by the parents under the guaranties were properly disallowed as deductions on the parents' consolidated returns, on the ground that such deductions would duplicate the deductions previously taken for the subsidiary's operating losses.

2. Whether the deductible losses sustained by the parents upon the liquidation of the subsidiary were correctly determined upon a consolidated rather than an individual basis, where use of the individual basis would permit the affiliated group to obtain a double deduction for the same economic loss.

STATUTE AND REGULATIONS INVOLVED

Section 141 (a), (b), and (d) of the Internal Revenue Code of 1939, and Sections 23.31, 23.34, 23.35 and 23.40 of Treasury Regulations 104 are set forth in the Appendix, *infra*, pp. 12-20.

STATEMENT

This case, which was tried on stipulated facts and issues, involves the consolidated income and excess

profits tax returns filed by three affiliated corporations for the years 1942-1945. (R. 35a). At all relevant times, the Denton & Anderson Company ("D & A") owned 96% of the Taylor-Winfield Corporation ("T-W"), and the latter owned all of the stock of the Warren City Tank & Boiler Company ("Warren City") (R. 9a).

T-W's investment in the stock of Warren City amounted to $327,934.28, and during the period from 1941 to 1943, D&A loaned Warren City $79,125.53. (R. 10a.) In addition, D&A and T-W were required to make guaranty payments to a Detroit bank as sureties on loans which Warren City had obtained from the bank. (R-10a-11a.) During the years 1943-1945, the guaranty payments which D&A made totalled $96,213.77, and those made by T-W totalled $473,569.88. (R. 11a.)

In 1942, Warren City sustained an operating loss of over $1,400,000. (R. 10a.) By filing consolidated returns with Warren City during the years 1942-1945, D&A and T-W were able to deduct $779,581.64 of this loss from their own current income. (R. 11a.) In 1945, Warren City was liquidated, and the proceeds were insufficient to pay any of the claims which D&A and T-W had against their subsidiary arising out of the foregoing loans and guaranty payments, or to return any part of T-W's capital investment in the company (R. 12a). We shall refer to both the claims and the capital investment as "claims." The unsatisfied claims of D & A totalled $175,339.30, and those of T-W totalled $801,504.16 (R. 13a-14a).

On their consolidated returns for the years 1943, 1944 and 1945, D&A and T-W deducted the full amount of their guaranty payments to the bank in the year of payment. (R. 11a-12a.) The Commissioner disallowed the deductions taken in the years 1943 and 1944, but partially allowed the deduction taken in 1945 (R. 12a-13a). He combined the aggregate claims which each corporation had against Warren City, and from this total of $976,834.46 he subtracted $779,581.64, which was the sum of the losses of Warren City that had already been deducted by D&A and T-W in their consolidated returns. (R. 14a.) The balance of $197,261.82 was allowed as a deduction on the consolidated return filed for 1945, and was prorated between D&A and T-W in proportion to their respective claims against Warren City. (R. 13a-14a.)

After paying the resulting deficiencies in full, the taxpayers brought suit for a refund (R. 15a-16a). They contended that the guaranty payments were fully deductible in the years when made, and that, in any event, the Commissioner erred in determining the amount of the allowable deduction for the year 1945 (R. 34a.) In a detailed opinion the District Court sustained the Commissioner's determination in all respects. (R. 35a-56a.) The Court of Appeals affirmed *per curiam* on the opinion of the District Court (Pet. 25-26.)

ARGUMENT

The decision below is correct, there is no conflict, and further review is not warranted.

1. This case involves a correct application of the established principle of tax law which prevents an affiliated group of corporations from taking double deductions for the same economic loss. To prevent such a result in cases where consolidated returns are filed, this Court and lower federal courts have uniformly held that a parent may take a deduction for the loss of money invested in or loaned to a subsidiary only to the extent that the claimed deduction exceeds any operating losses of the subsidiary which have already been deducted from the consolidated income of the affiliated group. *Ilfeld* v. *Hernandez*, 292 U.S. 62; *McLaughlin* v. *Pacific Lumber Co.*, 293 U.S. 351; *Edward Katzinger Co.* v. *Commissioner*, 129 F. 2d 74 (C.A. 7th); *Eljer Co.* v. *Commissioner*, 134 F. 2d 251 (C.A. 3d); *Commissioner* v. *Emerson Carey Fibre Products Co.*, 70 F. 2d 990 (C.A. 10th); *Singer Mfg. Co.* v. *United States*, 87 F. Supp. 769 (C. Cls.). To hold otherwise would mean that an affiliated group of corporations could take a double deduction for one economic loss, since the parent could take one deduction for the operating loss sustained by a subsidiary and another deduction for the latter's inability to repay the funds loaned or invested. *Ilfeld* v. *Hernandez*, *supra*.

In view of the established rule prohibiting such deductions, taxpayers concede (Pet. 5), as they must, that having deducted $779,581.64 of Warren City's operating loss in their consolidated returns, D&A and T-W are barred from taking any further deduction for the loss of the $79,125.53 which D&A loaned directly to Warren City, or the $327,934.28

which T-W invested in the stock of Warren City (R. 10a). However, taxpayers insist (Pet. 10-11) that they are entitled to a full deduction for the amounts they expended by making the guaranty payments on Warren City's behalf. In other words, taxpayers assert that the rule which prohibits double deductions when a parent loans money directly to a subsidiary is not applicable where the parent repays funds that the subsidiary has borrowed from other sources.

The District Court correctly held, however, that there is no real distinction between the two situations. (R. 45a-47a.) From a legal standjoint, D&A and T-W were in precisely the same position after they had paid Warren City's debts as they would have been in if they had loaned the same amount directly to Warren City. *Putnam* v. *Commissioner*, 352 U.S. 82, 85. Furthermore, from an economic standpoint, it makes no difference whether a parent advances cash which a subsidiary later loses in its operations, or pays debts which the subsidiary owes to third parties as a result of unprofitable operations which have already taken place. In either event, the operating loss of the subsidiary is paid for by the parent. To the extent that the parent has deducted the subsidiary's operating loss from its own current income, the parent would get a double benefit if it were allowed to take a further deduction for the amount spent in either providing or repaying the working capital that was lost by the subsidiary.

In the case at bar, D&A and T-W spent a total of $976,843.46 in either providing or repaying the working capital that was lost by Warren City. (R. 13a-

14a.) Since D&A and T-W derived a tax benefit from the loss of $779,581.64 of this capital by deducting Warren City's operating losses from their own current income (R. 14a), a double deduction would result if any part of that $779,581.64 could be deducted again. In other words, the balance of $197,261.82 represents the only part of the loss of D&A and T-W which they had not already deducted through the medium of filing consolidated returns with Warren City. Consequently, by claiming deductions for the full amount of their $569,783.65 guaranty payments (R. 11a-12a), D&A and T-W are seeking to deduct $372,-521.83 which they have already deducted once before. The courts below correctly held that they cannot do this. *Ilfeld* v. *Hernández, supra; McLaughlin* v. *Pacific Lumber Co., supra.*

There is no merit in petitioners' contention (Pet. 11-14) that the applicable Regulations[2] authorize

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[2] Section 141(a) of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 12-13) grants to an "affiliated group of corporations" the privilege of making a consolidated return in lieu of separate returns, "upon the condition" that all members of the group "consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b)", and provides that "The making of a consolidated income-tax return shall be considered as such consent." Subsection (b) authorizes the Commissioner, with the approval of the Secretary of the Treasury, to promulgate such Regulations "as he may deem necessary" to assure that the income is reported "in such manner as clearly to reflect the income- and excess-profits-tax liability and * * * to prevent avoidance of such tax liability."

Unless otherwise noted, all references to the Regulations will be to Regulations 104 dealing with the income tax. The

such a double deduction. As the District Court correctly stated (R. 40a-41a), the general provisions of Section 23.31(d) of Regulations 104, Appendix, *infra*, pp. 14-15, on which taxpayers rely (Pet. 13-14), are not controlling here because they are not applicable when it is "otherwise provided in these regulations". In the situation here presented, the governing Regulations are those contained in Section 23.40, Appendix, *infra*, pp. 19-20. That section provides that no member of an affiliated group of corporations can take a deduction during a consolidated return period on account of the worthlessness in whole or part of "any obligation (including accounts receivable, bonds, notes, debts, and claims of whatsoever nature) of any other corporation which was a member of the group", except as a loss resulting from termination of the debtor's operations, by liquidation or otherwise, in which case the loss will be deductible subject to the adjustments specified in Section 23.35.[3] Under this regulation, neither D&A nor T-W was entitled to any deduction for worthless claims against Warren City until its liquidation in 1945 (R. 12a), at which time a deduction was allowable only to the extent per-

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comparable sections of Regulations 110 (1941 ed.), dealing with the excess profits tax, are similar in all material respects.

[3] Since the broad language of this regulation covers both voluntary and involuntary claims, there is clearly no merit in taxpayers' assertion (Pet. 11-13) that the regulation is inapplicable to claims arising by operation of law—particularly where the result of such an interpretation would be the allowance of a double deduction. See *Ilfeld* v. *Hernandez*, 292 U.S. 62, 68.

mitted by Section 23.35 of the Regulations, Appendix, *infra*, pp. 18-19.

2. Under Section 23.35, any loss sustained by a creditor affiliate on the disposition of obligations of a debtor affiliate can be deducted only after making the basis adjustments provided by Section 23.34(c) or (d). In turn, Section 23.34(c), Appendix, *infra*, pp, 15-18, provides that "the *combined* aggregate" bases of the obligations in the hands of the creditor affiliates must be reduced by "the *sum* of the losses" of the debtor affiliate which were deducted on consolidated returns and could not have been availed of by the creditor affiliates if consolidated returns had not been filed. (Emphasis added.) As indicated in the Statement, *supra*, p. 4, this is precisely the procedure which the Commissioner here followed. Having determined that the combined claims of D&A and T-W exceeded the sum of their prior deductions for operating losses of Warren City by $197,261.82, the Commissioner then allocated this allowable deduction between D&A and T-W in proportion to their respective claims against Warren City, as provided by Section 23.35(e)(3) of the Regulations.

However, taxpayers assert (Pet. 8-9, 14) that because D&A and T-W were separate corporate entities, the Commissioner was required to reduce T-W's claims against Warren City by the amount of the latter's operating losses previously deducted by T-W, and was required to make a similar separate computation with respect to D&A's claims. As the District Court pointed out, after carefully analyzing the facts (R. 50a-54a), this method of adjustment would mean

that $156,528.60 of the operating loss deduction taken by D&A would not be eliminated from the claims of either D&A or T-W and, therefore, would be deducted a second time from the income reported by the corporations on their consolidated return for 1945. Since one purpose of consolidated returns is to reflect the true net income of the affiliated group (see *Burnet* v. *Aluminum Goods Co.*, 287 U.S. 544), the Regulations properly serve to prevent the group as a whole from taking such double deductions for one economic loss. Having chosen to file consolidated returns, taxpayers cannot now complain because the regulations governing such returns preclude them from utilizing their separate corporate entities in calculating their deductions with respect to the adjustments in question here. See *Greif Cooperage Corp.* v. *Commissioner*, 31 B.T.A. 374, affirmed, 85 F. 2d 365 (C.A. 3d); *Singer Mfg. Co.* v. *United States*, 87 F. Supp. 769 (Ct. Cls.). Petitioners' contention (Pet. 8-9, 13) that they have been denied the advantages of filing consolidated returns ignores the fact, pointed out by the District Court (R. 53a), that by filing such returns they could immediately deduct the losses they sustained because of Warren City's unprofitable operations, instead of having to wait until their claims against Warren City became worthless.

3. There is no conflict. The cases upon which petitioners rely (Pet. 7, 14), where the separate identity of affiliated corporations has been recognized, did not deal with, or question the validity of, the Regulations here involved. *Bush Terminal Building Co.* v. *Commissioner*, 7 T.C. 793, is clearly distinguishable

for the reasons given in the District Court's extended analysis of the case. (R. 54-56a).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1959

APPENDIX

Internal Revenue Code of 1939:

SEC. 141 [as amended by Section 159 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. CONSOLIDATED RETURNS.

(a) *Privilege to File Consolidated Income and Excess-Profits-Tax Returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making consolidated income and excess-profits-tax returns for the taxable year in lieu of separate returns. The making of consolidated returns shall be upon the condition that the affiliated group shall make both a consolidated income-tax return and a consolidated excess-profits-tax return for the taxable year, and that all corporations which at any time during the taxable year have been members of the affiliated group making a consolidated income-tax return consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated income-tax return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated returns shall include the income of such corporation for such part of the year as it is a member of the affiliated group. In the case of a corporation which is not a member of the affiliated group after March 31, 1942, of the last taxable year of such group which begins before April 1, 1942, such corporation shall not be considered a member of the affiliated group for consolidated income-tax-return purposes for such

year but shall be considered a member of such group for consolidated excess-profits-tax-return purposes for such year, and the consent required in the case of such corporation shall relate only to the consolidated excess-profits-tax regulations.

(b) *Regulations.*—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making consolidated income- and excess-profits-tax returns and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. Such regulations shall prescribe the amount of the net operating loss deduction of each member of the group which is attributable to a deduction allowed for a taxable year beginning in 1941 on account of property considered as destroyed or seized under section 127 (relating to war losses), and the allowance of the amount so prescribed as a deduction in computing the net income of the group shall not be limited by the amount of the net income of such member.

[26 U.S.C., 1946 ed., 141(a) and (b).]

* * * *

(d) *Definition of "Affiliated Group."*—As used in this section, an "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporation; and

(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

[26 U.S.C., 1952 ed., Sec. 141(d).]

* * * * *

Treasury Regulations 104, promulgated under the Internal Revenue Code of 1939:

Sec. 23.31 [as amended by T.D. 5127, 1942-1 Cum. Bull. 117]. *Bases of Tax Computation.*

* * * * *

(d) *Computations — Years Beginning After December 31, 1940.*

In the case of affiliated corporations which make, or are required to make, a consolidated return for a taxable year beginning after December 31, 1940, and except as otherwise provided in these regulations—

(1) The net income of such corporations shall be computed in accordance with the

provisions covering the determination of net income of separate corporations, except—

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in these regulations as intercompany transactions),

* * * *

Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable net income, shall not be eliminated. As used in this paragraph, the ferm "net income" includes the case in which the allowable deductions of a member (not including any net operating loss deduction) exceed its gross income.

* * * *

Sec. 23.34 [as amended by T.D. 5127, *supra*, and T.D. 5441, 1945 Cum. Bull. 214]. *Sale of Stock —Basis for Determining Gain or Loss.*

(a) *Scope of section.*—This section prescribes the basis for determining the gain or loss upon any sale or other disposition (hereinafter referred to as "sale") by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for *any taxable year*, of any share of stock issued by another member of such group (whether issued before or during the period that it was a member of the group and whether

issued before, during, or after the taxable year 1929), and held by the selling corporation during any part of a period for which a consolidated return is made or required under these regulations.

* * * *

(c) *Sales Made During Taxable Year for Which Return Required After March 1, 1945, Which Do Not Break Affiliation; and Sales Made at Any Time Which Break Affiliation.*

If the sale is made within a period during which the selling corporation is a member of the affiliated group, whether or not during a consolidated return period, and whether or not, as a result of such sale, the issuing corporation ceases to be a member of the group (not including sales made during a taxable year for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945, if such sale did not break the affiliation), the basis shall be determined as follows:

(1) The aggregate bases of all shares of stock of the issuing corporation held by each member of the affiliated group (exclusive of the issuing corporation) immediately prior to the sale shall be determined separately for each member of the group and adjusted in accordance with the Code, but without regard to any adjustment under the last sentence of section 113(a)(11) relating to losses of the issuing corporation sustained by such corporation after it became a member of the affiliated group.

(2) From the combined aggregate bases as determined in paragraph (1), there shall be deducted the sum of the losses of such

issuing corporation sustained during taxable years for which consolidated income tax returns were made or were required (whether the taxable year 1929 or any prior or subsequent taxable year) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as a net loss or net operating loss in computing its net income for such taxable years if it had made a separate return for each of such years, reduced by any losses of the issuing corporation apportioned under this section to its stock sold or otherwise disposed of in a prior transaction, disregarding any transaction between members of the affiliated group during a consolidated return period which did not constitute a partial liquidation of the issuing corporation. For any taxable year in which the group sustained a consolidated loss not availed of in prior or subsequent years as a deduction under net loss or net operating loss provisions, the amount deducted under this paragraph shall be further reduced by an amount equal to that proportion of such consolidated loss which the loss of the issuing corporation for the year in which such loss was sustained bears to the aggregate losses of the members of the group for such year;

(3) The sum of the aggregate bases of all shares of stock, after making the deduction under paragraph (2), shall then be apportioned among the members of the affiliated group which hold stock of the issuing

corporation, by allocating to each such member that proportion of the sum of the aggregate bases so reduced which the aggregate basis of the stock in the issuing corporation held by such member bears to the sum of the aggregate bases;

* * * *

Sec. 23.35 [as amended by T.D. 5127, *supra*, and T.D. 5441, *supra*]. *Sale of Bonds or Other Obligations—Basis for Determining Gains or Loss.*

In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated income tax return for any taxable year, of bonds or other obligations issued or incurred by another member of such group (whether or not issued or incurred while it was a member of the group and whether issued or incurred before, during or after the taxable year 1929) and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations, the basis of each bond or obligation, for determining the gain or loss upon such sale or other disposition, determined in accordance with the Code, but without regard to any adjustment under the last sentence of section 113(a)(11), shall be decreased (except as otherwise provided in this section) by the excess, if any, of the aggregate of the deductions computed under paragraph (c)(2) or (d) of section 23.34 over the sum of the aggregate bases of the stock of the debtor corporation as computed under paragraph (c)(1) or (d), as the case may be, held by the members of the group. The adjustment with respect to so much of such deductions as is based upon losses sus-

tained during the taxable year 1929 and subsequent taxable years for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945 (the date on which Treasury Decision 5441 was filed with the Division of the Federal Register), and availed of on consolidated returns filed for such years shall be made only in those cases in which the sales or other disposition of such bonds or other obligations resulted in a loss. (See, also, section 23.40, relating to disallowance of loss upon intercompany bad debts.)

Se. 23.40 [as amended by T.D. 5127, *supra*, and T.D. 5244, 1943 Cum. Bull. 439]. *Bad Debts.*

(a) *Deduction During Consolidated Return Period.*

No deduction shall be allowed during a consolidated return period to any member of the affiliated group on account of worthlessness in whole or in part of any obligation (including accounts receivable, bonds, notes, debts, and claims of whatsoever nature) of any other corporation which was a member of the group as of the last day of the taxable year or which was liquidated by the group during such year, except as a loss resulting from a bona fide termination of the business and operations of such other corporation, whether in liquidation or otherwise, in which case the loss will be computed subject to the adjustments specified in section 23.35; * * *.

(b) *Limitation of Allowance After Consolidated Return Period.*

With respect to obligations (including accounts receivable) of a member of an affiliated group acquired in any way by another member of the

group prior to or during any taxable year subsequent to 1928 for which a consolidated income or excess profits tax return was filed, the adjustments prescribed with respect to the allowance of losses upon the sale of bonds shall be applicable to the allowance of any bad debt deduction for any period subsequent to the consolidated return period. (See section 23.35.)

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